

Summary

The business model of the Department is primarily cost leadership by achieving low operating cost per dollar of revenue collected. This is accomplished by offering high volumes of standardized products (tax forms) with no-frills products and limited personalization of services. Most value capture is through voluntary compliance. The IRS estimates that voluntary compliance is approximately 82%.

The secondary business model pursues a differentiation strategy for debtors. This is a much smaller target customer base that has very specific needs for debt reduction. The Department has unique resources and capabilities to capture value such as attachments, garnishments and payment plans. This differentiation drives additional profitability and has shown consistent return on investment. The gap between voluntary compliance and total liability is referred to as the tax gap. Using the IRS estimates, the theoretical tax gap for Tax Year 2015 in North Carolina, and subject to involuntary compliance programs, was \$3,622,096,800.

Reducing the tax gap is difficult and requires specialized tools and skilled staff. It was asked of the Agency to try to determine at what point investments in the involuntary compliance programs would no longer have significant return on investment. While this is difficult to determine, the Exams and Collections divisions are proposing new and refined programs that would require an investment of \$4.7m and would return a net of \$131.7m in the first year.

Overview

The Internal Revenue Service (IRS) estimates that over the past 30 years, the tax gap has ranged from 16% to 20% of total tax liability. Some view the tax gap as a major revenue source that could be used to close the federal budget deficit without raising taxes. In practice, though, the potential revenue gains from proposals to improve enforcement are somewhat limited. The latest IRS tax gap report was prepared in 2016 and covered tax years 2008-10. (IRS Research, Analysis, and Statistics, 2016). For those years, the IRS reported a \$458 billion gross tax gap (slightly over 18% of tax liability), of which \$52 billion (11% of the gap) was eventually recovered through voluntary late payments and enforcement activities. That left a net tax gap of about \$406 billion.

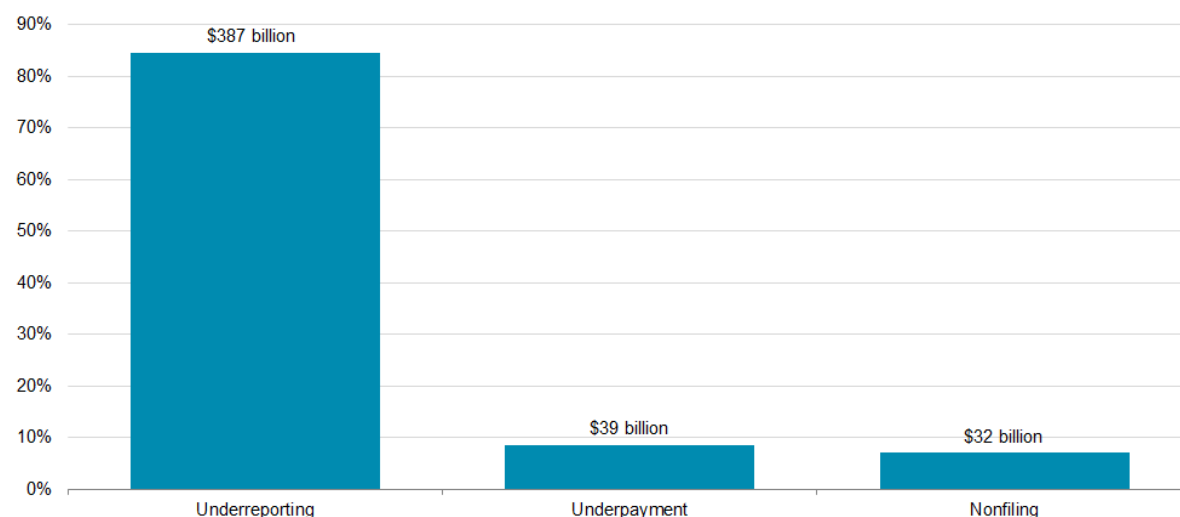
- Underreporting on timely filed tax returns makes up the bulk of it; \$387 billion or 85% of the gross tax gap. (figure 1)
- Non-filing and underpayment of reported taxes account for just over 15% of the gross tax gap

FIGURE 1

Components of the \$458 Billion Gross Tax Gap 2008-10



Share of gap



Source: Internal Revenue Service.

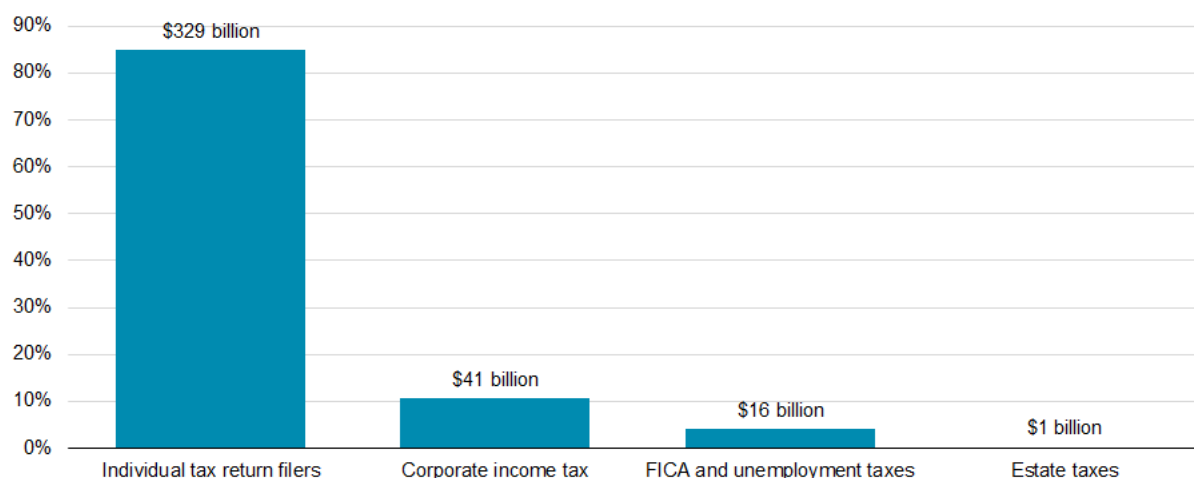
Underreporting on individual income tax returns alone (including self-employment tax) was \$329 billion (figure 2); about 85 percent of the underreporting tax gap in 2008-10. Almost 60 percent of the underreported individual tax is owed on business and self-employment income, which the IRS has no easy way to verify independently. About 11 percent of the underreporting gap is attributable to corporate income tax, and only 0.3 percent to the estate tax.

FIGURE 2

Components of the \$387 Billion Underreporting Gap 2008-10



Share of gap



Source: Internal Revenue Service.

Individual taxpayers fail to report about 63 percent of income from sources for which there is no information reporting, such as sole proprietorships. In contrast, only 7 percent of income from easily verified sources—interest, dividends, and pensions—goes unreported. When income is subject to both information returns and tax withholding, as is the case with wages, only about 1 percent goes unreported.

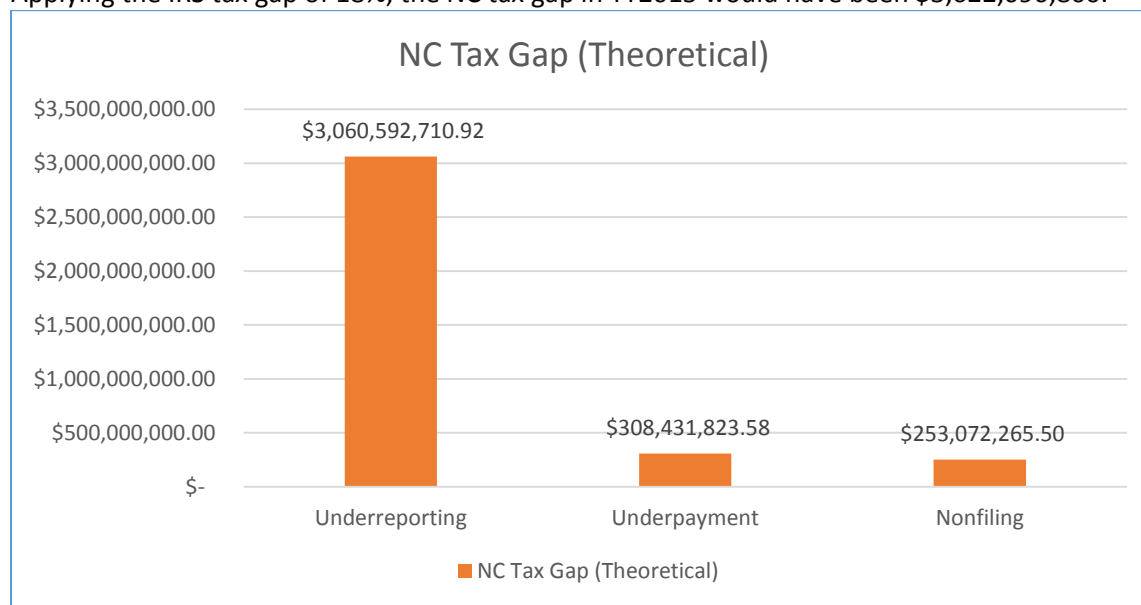
NC Department of Revenue

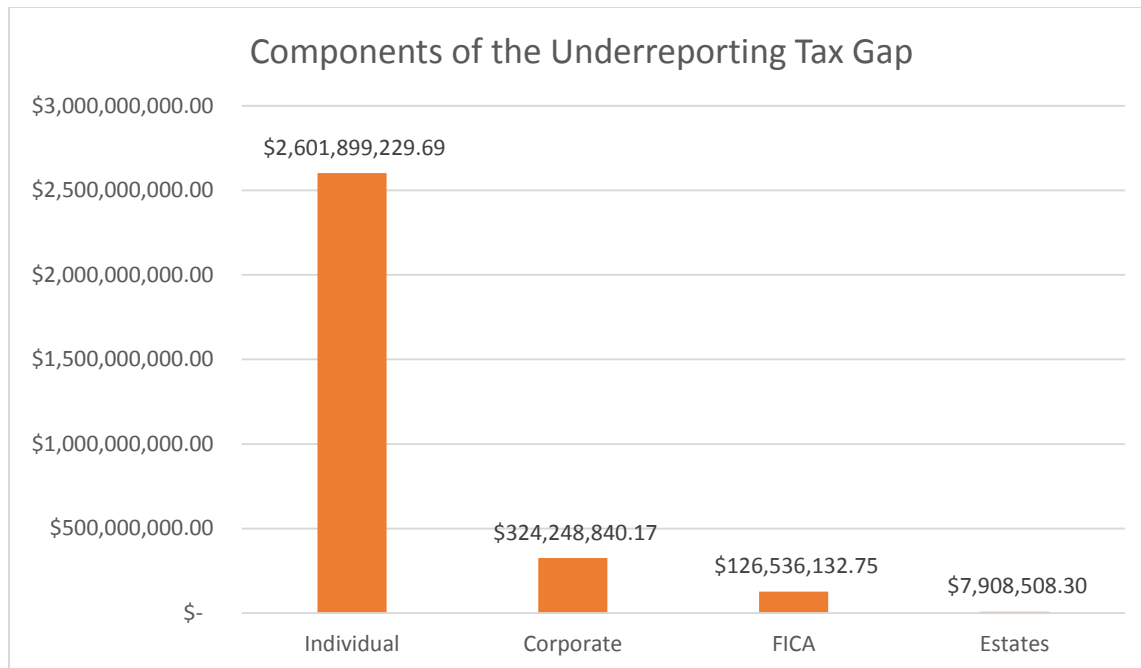
According to the 2016 North Carolina Comprehensive Annual Financial Report (page 34) tax revenue for TY2015 was \$25.1B but the three schedules that are similar to the IRS are described in Figure 3 and total \$20,122,760,000.

Figure 3: 2015 CAFR

NC CAFR Tax Year 2015 Tax Revenue	
Individual income	\$11,980,791,000
Corporate income	\$1,272,879,000
Sales and use tax	\$6,869,090,000

Applying the IRS tax gap of 18%, the NC tax gap in TY2015 would have been \$3,622,096,800.





- For Tax Year 2015, Exams assessed \$740,339,925 and collected \$404,719,737.
- Collections had an AR balance of \$1,176,222,899.69 (does not include USUB and Excise Tax) and collected \$624,215,689.
- The AR balance in Excise Tax was \$81,183,703.24.
- The AR balance in USUB was \$499,459,200.38

The calculated NC TY15 tax gap is:

Item	Amount
Exams Assessed	\$740,339,925.00
Collections AR Balance	\$1,176,222,899.69
Excise Tax AR Balance	\$81,183,703.24
USUB AR Balance	\$499,459,200.38
NC TY15 Calculated Tax Gap	\$2,497,205,728.31

Total NC FY15 calculated tax gap was \$2,497,205,728.31 compared to the theoretical tax gap of \$3,622,096,800.

Examination Division

The Examination Division's primary objective is to identify noncompliance with state tax laws, audit the books and records of individuals and businesses not in compliance, and determine the accurate tax liability and collect unpaid revenue owed to the State. The Examination Division's goal is to realize the lowest possible operating cost per dollar of revenue assessed. The Division accomplishes this goal by establishing an annual multi-prong audit strategy which includes over 50 specific initiatives. The initiatives range from data matching automation to an extremely high level of complexity involving reconstruction of records and forensic accounting.

The Examination Division strategically develops and implements audit programs designed to maximize revenue recovery and increasing the voluntary compliance rate. A few examples of our strategic initiatives:

- We have a large program focused on income shifting transactions within large multi-national and multi-state corporations.
- We have multiple initiatives designed for sales, use, partnership, withholding, and cigarette/tobacco tax schedules. Most notably our cash intensive audit program is designed to identify taxpayers that deal heavily in cash and underreport sales. Audits within this category are very technical, involve indirect methods of audit, and result in multiple tax schedule adjustments.
- We have a large audit program that identifies the more recalcitrant taxpayers that are considered non-filers.
- We have a very robust refund fraud and identity theft refund fraud program.
- For our underground economy, we have many audit initiatives including our ITIN withholding program.

The Examination Division generates between \$720 - \$745 million dollars in non-compliance revenue on an annual basis. In addition, the Examination Division collects over 40% of our assessments within 90 days. The remainder of our assessments flow to our Collection Division and are included within their process of collection activity of Account Receivable over time.

The Examination Division has developed a specialized strategy designed to augment existing initiatives and Pilot new programs for the defined objective of generating an additional net of \$90 million in non-compliance revenue in year 1, and \$111 million in non-compliance revenue in year 2 above our established baseline. Revenue generation estimated for accelerating existing initiatives is calculated using historical data from the inception of the initiatives and auditor capacity. Development of new Pilot initiatives is derived from analyzing data of existing trend markers in tax non-compliance, and availability of new technology to streamline our audit process.

Expanded Programs

The Examination Division is proposing to expand several audit programs that are already in existence but have not fully captured all value. The expected return for the expanded programs is \$83,594,033 and is described in the following table:

Audit Program	Additional Revenue 1st Year	Cost	Return Year 1
IRMF combine TY13/TY14/TY15	\$80,000,000.00	\$72,267.07	\$79,927,732.93
Discovery team	\$500,000.00	\$72,267.07	\$427,732.93
Interstate satellite auditor - Cleveland, OH	\$500,000.00	\$98,452.31	\$401,547.69
Interstate satellite auditor - Minneapolis, MN	\$500,000.00	\$98,452.31	\$401,547.69
Interstate satellite auditor - San Francisco, CA	\$500,000.00	\$98,452.31	\$401,547.69
Interstate satellite auditor - Houston, TX	\$500,000.00	\$98,452.31	\$401,547.69

Large Case Corporate Team-Charlotte	\$500,000.00	\$98,452.00	\$401,548.00
Large Case Corporate Team-Raleigh	\$500,000.00	\$98,452.00	\$401,548.00
Large Case Corporate Team-Greensboro	\$500,000.00	\$98,452.00	\$401,548.00
Bilingual team	\$500,000.00	\$72,267.07	\$427,732.93

New Programs

The Examination Division is proposing several new audit programs as well. The expected return for the new programs is \$7,491,752 and is described in the following table:

Audit Program	Additional Revenue 1st Year	Cost	Return Year 1
IRMF combine TY13/TY14/TY15	\$80,000,000.00	\$72,267.07	\$79,927,732.93
Discovery team	\$500,000.00	\$72,267.07	\$427,732.93
Interstate satellite auditor - Cleveland, OH	\$500,000.00	\$98,452.31	\$401,547.69
Interstate satellite auditor - Minneapolis, MN	\$500,000.00	\$98,452.31	\$401,547.69
Interstate satellite auditor - San Francisco, CA	\$500,000.00	\$98,452.31	\$401,547.69
Interstate satellite auditor - Houston, TX	\$500,000.00	\$98,452.31	\$401,547.69
Large Case Corporate Team-Charlotte	\$500,000.00	\$98,452.00	\$401,548.00
Large Case Corporate Team-Raleigh	\$500,000.00	\$98,452.00	\$401,548.00
Large Case Corporate Team-Greensboro	\$500,000.00	\$98,452.00	\$401,548.00
Bilingual team	\$500,000.00	\$72,267.07	\$427,732.93
NC-3 employer non-filer	\$0.00	\$80,864.00	(\$80,864.00)
Corporate MEF query	\$1,000,000.00	\$72,267.07	\$927,732.93
Partnership MEF query	\$1,000,000.00	\$72,267.07	\$927,732.93
Large Case Sales/Use tax team	\$1,000,000.00	\$80,864.00	\$919,136.00
Proration cases	\$1,000,000.00	\$72,267.07	\$927,732.93
S-corporation	\$500,000.00	\$72,267.07	\$427,732.93
1099K	\$1,000,000.00	\$80,864.00	\$919,136.00
Perimeter travel team - Western Area	\$500,000.00	\$80,864.00	\$419,136.00
Perimeter travel team - Capital City Area	\$500,000.00	\$80,864.00	\$419,136.00
Perimeter travel team - Eastern Area	\$500,000.00	\$80,864.00	\$419,136.00
S/U business classification query	\$500,000.00	\$80,864.00	\$419,136.00
Occupational	\$500,000.00	\$80,864.00	\$419,136.00
1099K non-filer	\$500,000.00	\$72,267.07	\$427,732.93

Support

In order to support these initiatives, additional staff is needed in customer service and IT.

Staff	New Positions	Cost
IRMF Processing Assistant	2	\$48,000.00
Service Center Staff	2	\$48,000.00
Business Intelligence	1	\$92,231.00
Business Intelligence	1	\$92,231.00
Mainframe Applications Development (ITAS)	1	\$97,692.00

Applications Development (MeF)	1	\$97,692.00
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Collections Division

The Collections Division's primary objective is to actively pursue the collection of taxes due the State in a fair, uniform, and impartial manner. The goal of the Collection Division is to maximize effectiveness and efficiency in such a manner as to achieve the highest possible return for each dollar spent in the collection process. This is done by ensuring collection cases are worked at the lowest possible cost to achieve resolution. Collection cases are worked in a variety of ways based on the characteristics of the case. The age, amount, location, or tax type of the case may determine which collection tool is used when the liability is deemed collectible.

The Collection Division averages \$570 million per year in delinquent tax collections. These collections come primarily from the individual income, sales & use, withholding, and corporate and franchise tax schedules. Examples of specific initiatives used in the collection process include the following:

*Financial Institutions Records Match (FIRM)-Utilizes a 3rd party vendor to match delinquent taxpayers and their bank accounts

*Auto-Attachment-A centralized repository of taxpayers' assets, including w-2, 1099, and bank account data used to automatically generate garnishments

*ABC Compliance Initiative- Data matching with the Alcohol Beverage Control Commission to ensure businesses with ABC permits are in compliance with the State's tax laws

*Levy Program- Used primarily for businesses that accrue relatively large liabilities of sales & use or withholding taxes

*Installment agreements-Under certain circumstances taxpayers are allowed to make installments when they are unable to pay the liability in full

*Corporate Suspension- Corporations that have not filed corporate returns can be Revenue Suspended with the North Carolina Secretary of State

Expanded Programs

The Collections Division has developed a specialized strategy designed to augment existing initiatives for the defined objective of generating an additional net of \$39 million in non-compliance revenue in year 1. Revenue generation estimated for accelerating existing initiatives is calculated using historical data from the inception of the initiatives and Revenue Officer capacity.

Collections Program	New Positions	Additional Revenue 1st Year	Cost	Annual Return
Assign AR at collectable levels - Asheville	4	\$5,261,828.89	\$253,943.13	\$5,007,885.76
Assign AR at collectable levels - Charlotte	9	\$10,176,689.47	\$491,141.08	\$9,685,548.39
Assign AR at collectable levels - Durham	2	\$2,565,135.63	\$123,796.99	\$2,441,338.65
Assign AR at collectable levels - E City	1	\$844,164.90	\$40,740.56	\$803,424.34
Assign AR at collectable levels - Fayetteville	5	\$5,344,508.54	\$257,933.36	\$5,086,575.18

Assign AR at collectable levels - Greensboro	3	\$3,037,183.29	\$146,578.66	\$2,890,604.63
Assign AR at collectable levels - Greenville	4	\$5,195,594.31	\$250,746.55	\$4,944,847.76
Assign AR at collectable levels - Hickory	2	\$2,590,250.01	\$125,009.04	\$2,465,240.96
Assign AR at collectable levels - Raleigh	2	\$2,244,472.14	\$108,321.32	\$2,136,150.82
Assign AR at collectable levels - Rocky Mount	1	\$1,445,591.41	\$69,766.24	\$1,375,825.18
Assign AR at collectable levels - Wilmington	2	\$2,378,576.37	\$114,793.38	\$2,263,782.99
	35	\$41,083,994.95	\$1,982,770.31	\$39,101,224.64

Support

In order to support these initiatives, additional staff, team leaders, are needed. With the addition of 35 new Revenue Officers, we anticipate needing 6 supervisors at a fully loaded annual cost of \$377,674. With the addition of the team leaders, the total annual cost is adjusted to \$2,360,445.21 with an annual adjusted return of \$38,723,549.74.